

The Great Bull Market in Bonds Is Over – What Comes Next?

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Introduction

In 2008, for the first time in 50 years, the 3.4% yield on the benchmark 10-year Treasury bond dipped below the 3.5% dividend yield on the S&P 500 stock index. The yield on the 10-year Treasury bond has since declined to near 2.8%, driven by accommodative Federal Reserve policy and continued investor demand for bonds as a “safe haven,” seemingly without regard to valuation levels. Corporations are taking advantage of the low yields investors are willing to accept by issuing bonds at a record pace and at yields that would have been unheard of just a few years ago.



The following are examples of recent 2010 corporate debt issues:

PepsiCo Inc.	\$500 million	3 year notes yielding 0.88%
Colgate-Palmolive Co.	\$186 million	5 year notes yielding 1.38%
Johnson & Johnson	\$540 million	10 year notes yielding 2.95%
Microsoft Corp.	\$990 million	30 year notes yielding 4.50%
Norfolk Southern Corp.	\$250 million	100 year notes yielding 5.95%

Interest rates have been in a secular decline since 1986 and are currently near 50-year lows. While bond investors have enjoyed strong returns over this period, two points are clear. First, with yields already near record low levels, the opportunity for bonds to provide strong future returns is limited. Second, while no one knows precisely when yields will reverse course and move higher, the result will be material declines in bond prices and portfolio losses. For bond investors, now is the time to consider shortening maturities and investing in variable rate and Treasury Inflation-Protected Securities (TIPS). Recently, one hedge fund manager went as far as stating that, “shorting bonds is setting up to be the trade of the decade.”

To achieve acceptable performance and to mitigate risk, disciplined investors pay close attention to the price, or valuation level, of each portfolio investment. In the current environment of “fully-valued” bond prices, it makes sense to consider re-allocating a portion of bond investments to other alternatives. By many measures, stocks are reasonably priced. Stocks are also highly liquid and can provide attractive return potential regardless of the future direction of interest rates. Hedge funds investing in both stocks and bonds can invest both long in undervalued securities and short in overvalued securities, providing the ability to generate gains with lower volatility and lower net exposure to financial markets.

Fundamental Value Investing

Throughout their careers, Ben Graham, David Dodd, Warren Buffett and other legendary fundamental value investors maintained a strong conviction that over time, investment prices are “tethered” to values determined by their underlying fundamental characteristics. For example, bond prices will change based on the perceived creditworthiness of the issuer, or ability to repay. Changes in the earnings growth rate of a company will influence its stock price.

Non-fundamental factors such as war, changes in government policies and regulation and past trends in investment performance also impact prices. Investments fall in and out of favor over time, and price dislocations are created, whereby the price of an investment deviates from its value as supported by the underlying fundamentals.

A specific investment that has fallen out of favor will eventually be perceived as “undervalued” and will attract buying demand. As early investors purchase the investment, its price will be driven up. Later investors will see the positive price trend and may also buy the investment on the expectation that the gains will continue. When the last investor has paid the highest price, the pendulum will ultimately shift and the investment’s price will begin to decline to a “fair” level supported by its underlying fundamentals. Hence the investment adage: “What the wise man does in the beginning, the fool does in the end.” In a repeating cycle, far too many investors focus on recent price trends as an investment strategy rather than ask “at what price is the investment a good value?”

Another common flaw in decision-making is to assume that investments will generate returns equal to their “long term” historic averages. Stocks returned 9.8% annually from 1926 to 2009. 20-year Treasury bonds returned 5.4% annually over the same period. However, returns in other “long term” periods are markedly different. Over the past 20 years, stocks returned 8.2%, just equal to the 8.2% return provided by bonds (which benefited from the secular decline interest rates). For the past ten years, stocks generated negative returns of -1.0% annually, far below the 7.7% annual return provided by bonds.

Annualized Returns				
Year	S&P 500	20-Year Treasury Bond	90-Day Treasury Bill	Inflation
1926-2009	9.8%	5.4%	3.7%	3.0%
1989-2009	8.2%	8.2%	3.8%	2.7%
1999-2009	-1.0%	7.7%	2.8%	2.5%



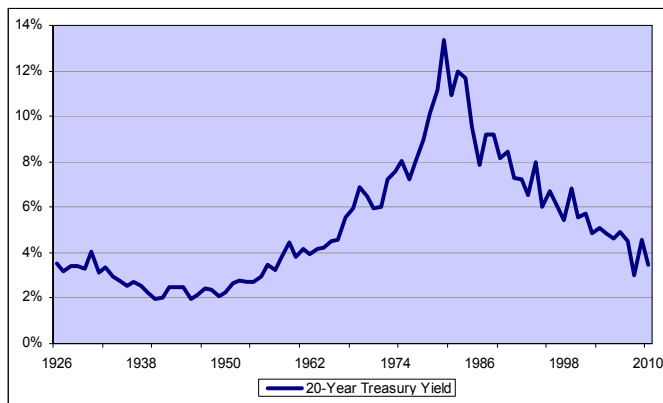
It is important to ask: “Are bonds both less volatile and capable of providing higher returns than stocks in the future?” An alternative conclusion is that bond prices have reached “fully-valued” levels, are becoming dislocated from their fundamentals and are likely to regress to “fair” price levels in the future.

A Brief History of Bond Valuations (Interest Rates)

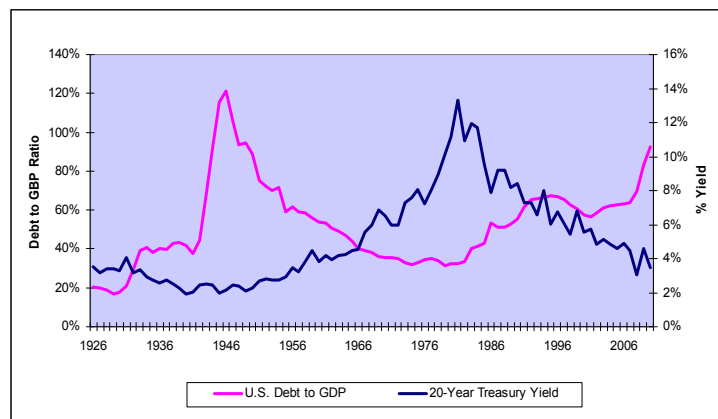
Interest rates, as defined by Treasury yields, are driven by supply and demand, government policy, expectations for future inflation and many other factors. Corporate bond yields are influenced by Treasury yields and also incorporate measures of the creditworthiness of the specific issuer such as balance sheet leverage and cash flow trends. Yields indicate the price investors are willing to pay for bonds. While yields fluctuate in the short term, historically they have demonstrated low volatility, shifting gradually over long time periods.

Throughout the Great Depression of 1929-1933, Treasury yields declined as economic growth and inflation turned negative. Under the New Deal in the 1930's, the Treasury, under the direction of the Federal Reserve, issued debt at low interest rates to fund public works and America's preparation for and entry into World War II. These actions were effective in reducing the unemployment rate from 24% in 1932 to 4% in 1946. As jobs became more secure and economic growth more stable, price inflation returned. While these conditions would normally result in rising interest rates, the government was so concerned about the potential for a return to depression conditions that it agreed publicly to purchase all 10-year Treasury bonds at a yield of 2.25%. Over the decade of the 1940's, inflation averaged 6.1% while 20-year Treasury yields averaged only 2.3% (real interest rates, or yield minus inflation, averaged -3.8% over the decade).

Under the Treasury Accord of 1951, the Federal Reserve abandoned its policy of keeping yields artificially low. As shown in the chart to the right, the 20-year Treasury yield began a long upward trend from 2.7% in 1951 to a peak of 13.3% in 1981. Upward wage pressure and energy supply shortages contributed to high and tenacious inflation. In 1981, Chairman Volcker's Federal Reserve aggressively increased the short term federal funds lending rate to restrain the expansion of credit and reduce inflation. Inflation, which had peaked at 13.5% in 1980, declined to 3.2% by 1983. Bond yields, which include a component to compensate investors for future expected inflation, began their long descent to current levels in 2010. By comparing the yields on Treasury bonds with similar maturity TIPS, it can be determined that the market currently expects an inflation rate of 2.0% over the next ten years. At current levels, an investor in 10-year Treasury bonds will be compensated at a real annualized rate of only 0.8% (2.8% 10-year Treasury yield minus 2.0% expected inflation rate).



From a supply and demand perspective, as the level of U.S. Government debt issued increases, investors will require a higher yield to be enticed to invest. A higher supply, with no change in demand, will result in lower prices and higher yields (absent policies to artificially keep yields low). As shown in the chart below, over the past 70 years, U.S.



government debt exceeded 90% of Gross Domestic Product (GDP) in only two periods. The ratio peaked at 121% in 1946 and then declined to a low of 32% in 1979. The 1946 peak was followed by a multi-decade climb in yields. The U.S. debt/GDP ratio has risen rapidly over the past five years, to 93% in 2010. Federal Reserve policy is again focused on stimulating job creation, this time coming out of the Great Recession of 2008-2009. U.S. government debt now totals \$13.7 trillion, as compared to GDP of \$14.7 trillion. Over time, the excess credit currently being pumped into our economy will undoubtedly translate into inflationary expectations and higher future interest rates.

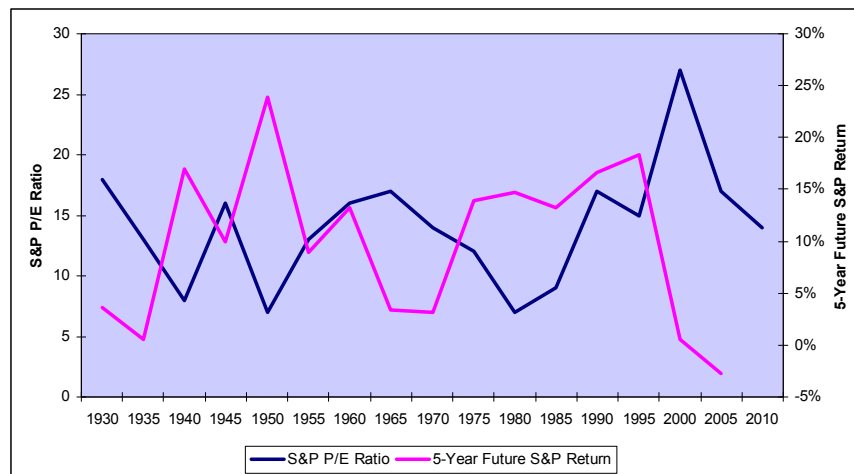


The important take-away from the decade of the 1940's is that the Federal Reserve can keep interest rates low for very long periods if it is committed to fighting against high unemployment and potential economic contraction. In many ways, what we see in the Fed's Quantitative Easing 2 (QE2) policy in 2010 is similar to the policies utilized in the 1940's. While the timing is unknown, we can be confident that these policies will again result in higher interest rates in the future.

While the similarities of the U.S. debt/GDP ratios in 1946 and 2010 are noteworthy, there are important differences that understate the potential impact of 2010 deficit spending. While Social Security existed in 1946, funding requirements for benefits were negligible. In 2010, the present value of unfunded Social Security liabilities totals \$5.4 trillion, an amount that is excluded from the calculation of total U.S. debt. Medicare was only established in 1965 and has expanded to cover 45 million citizens. Medicare and Medicaid outlays currently comprise 5% of GDP and are projected to rise to 12% of GDP by 2030. Today, U.S. government agencies implicitly guarantee over 80% of U.S. residential mortgage loans for a total of \$10 trillion. One out of seven of these loans is currently delinquent or in foreclosure. Expanded U.S. government programs including 99 week unemployment benefit payments for 30 million citizens and food stamps for 41 million citizens also put more pressure on the budget deficit. Today, while we have significant government stimulus programs, the spending has not provided the intended impact of growth in jobs and increased economic output. In the aggregate, these differences translate into a much higher probability that the debt/GDP ratio will not materially decline in the near future.

Stock Valuations

A commonly used measure of value for stocks is the price to earnings (P/E) ratio. As shown in the chart below, looking at five-year periods since 1930, the P/E ratio of the S&P 500 has ranged from a low of 7x in 1950 and 1980 to a high of 27x in 2000. At the "low P/E" dates of 1950 and 1980, the S&P 500 generated future five-year annualized returns of 23.9% and 14.7%, respectively. At the "high P/E" date of 2000, the S&P 500 generated a five-year future annualized return of only 0.5%. In 2010, the S&P 500 P/E ratio has declined to approximately 14x. By this measure of value, stocks are "cheaper" than long term averages and may be poised to generate attractive returns going forward.



After the Great Depression of 1929-1933, stocks were avoided as speculative investments. Higher dividend yields, another measure of the value of stocks, were required to attract investors. Stock dividend yields exceeded 20-year Treasury bond yields through 1957.

The "hangover" from the Great Recession of 2008-2009 undoubtedly now plays a similar role in driving capital flows into the perceived "safety" of bonds and out of perceived "risky" assets such as stocks. After experiencing a 50.9% decline in value in the S&P 500 in 2007-2009, investors withdrew from the stock market and re-allocated to bonds, which held up much better during the crisis. Of course, these investors would have been better off had they re-allocated to bonds BEFORE the crisis, when their safety would have been much more valuable. Despite high bond valuations, investor capital continues to flow into bond funds from stock and money market funds at a strong rate. Investors now apparently believe bonds will provide both higher returns than money markets and greater safety than stocks. We strongly disagree and believe that at current price levels, bond investors will be disappointed with future returns and are assuming significant risk of capital loss.



	2009	YTD October 2010
Equity Mutual Fund Capital Flows	- \$35 billion	- \$32 billion
Money Market Capital Flows	- \$280 billion	- \$516 billion
Bond Mutual Fund Capital Flows	+ \$421 billion	+ 272 billion

The Challenging Future

Investors with ample capital to fund future obligations may be unconcerned with the high prices and low yields currently offered by bonds. However, if interest rates do rise in the future, the potential for capital loss is meaningful and more amplified the longer the maturity of the bond. As shown in the chart below, a 5-year maturity bond yielding 3% would lose 4.5% of its value if interest rates increased to 4%, and a 20-year maturity bond would lose 13.7% of its value. While bond values will appreciate if rates decline, in the context of the low level of current market interest rates, the potential for further gains is limited when compared to the capital loss that will result if rates move upward toward more normalized levels.

It is clear that most investors do not have “ample capital” and are not “unconcerned.” As an example, the Pension Protection Act of 2006 established three categories to assess the level of solvency of defined benefit pension plans; green zone (fully funded) plans have adequate assets to fund required future obligations, yellow zone (endangered underfunded) plans have less than 80% of required assets and red zone (critically underfunded) plans have less than 65% of required assets. In 2010, less than 20% of defined benefit plans are fully funded, in the green zone. As illustrated in the chart below, data for U.S.

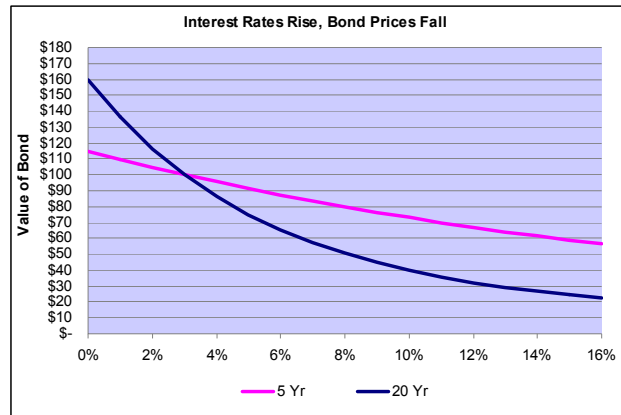
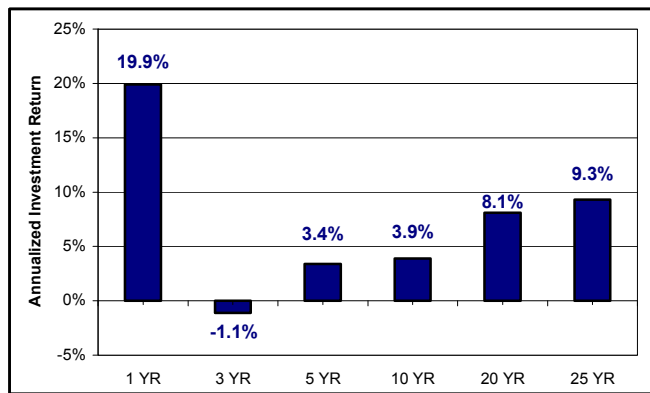


Chart assumes a 3% coupon for all maturities.



public pension plans show that while the median investment return achieved in 2009 was a healthy 19.9%, the return performance for the 3, 5 and 10-year periods (-1.1%, 3.4% and 3.9%, respectively) has fallen well below the generally assumed 7-8% required return to fund future obligations.

Under most realistic scenarios, consistently achieving an aggregate portfolio return of 8% is challenging and virtually impossible using only bond investments. If investments are allocated between both bonds and stocks, and each asset class provides future returns equal to their “long-run” averages since 1926, the return target can be reasonably met.

A 50%/50% bonds to stocks allocation would return 7.6% and a 30%/70% allocation would return 8.5%.

Portfolio Allocation	Long-Run Bond Return	Long-Run Equity Return	Aggregate Return
50% Bonds / 50% Equities	5.4%	9.8%	7.6%
30% Bonds / 70% Equities	5.4%	9.8%	8.5%

If bond yields remain unchanged from current levels and stocks continue to provide returns at long-run average yields, achieving future return targets becomes more difficult. A 50%/50% allocation would return 6.7% and a 30%/70% allocation would return 7.9%.

Portfolio Allocation	Long-Run Bond Return	Long-Run Equity Return	Aggregate Return
50% Bonds / 50% Equities	3.5%	9.8%	6.7%
30% Bonds / 70% Equities	3.5%	9.8%	7.9%



Lastly, if bond yields increase in the future, capital losses could offset interest income earned, resulting in 0% returns or worse for bonds. Under this scenario, substantial bond allocations become problematic. A 50%/50% allocation would return 4.9% and a 30%/70% allocation would return 6.9%.

Portfolio Allocation	Long-Run Bond Return	Long-Run Equity Return	Aggregate Return
50% Bonds / 50% Equities	0.0%	9.8%	4.9%
30% Bonds / 70% Equities	0.0%	9.8%	6.9%

20-year Treasury bonds currently yield about 3.5%, well below the long term average. Other than in a “doomsday” outcome, it is difficult to articulate a scenario where Treasury yields decline sufficiently further in the near future to provide the capital appreciation that would be required to achieve returns equal to the long-run average.

Of course, stocks also have the potential to underperform long term average returns or to provide negative returns. However, the relatively inexpensive price of stocks at current levels provides a “value” cushion against material price declines. In contrast, bonds can be purchased only at very high prices relative to their long term average price.

How Will Bonds Perform if Interest Rates Rise?

The 40 years from 1940-1979 provides an example of a long period of rising bond yields. As discussed above, changes in yields have a greater impact on bonds with longer maturities and lower annual interest payments. As yields first rise in a low yield environment, capital losses are more pronounced as low interest payments only partially offset capital losses. As yields rise further, higher annual interest payments are more effective in offsetting or dampening capital losses.

In the 1950’s, yields on 5-year Treasury notes increased 375 basis points, from 1.23% to 4.98%, but the notes still provided a positive 1.30% annualized return to investors. As the note maturities were shorter term, investors had the opportunity to reinvest bond proceeds at maturity in newer, higher-yielding bonds, providing a cushion to valuation declines. In the same decade, yields on 20-year Treasury bonds increased only 238 basis points, from 2.09% to 4.47%, but the bonds generated an annualized return of -0.10%. With longer maturities, investors did not have the opportunity to receive principal at par at maturity and reinvest in higher-yielding bonds, and capital declines more than offset total interest earned. This period has similarities to the low bond yield environment of 2010.

In the 1970’s, bond yields increased dramatically from already high levels. Yields on 5-year Treasury notes increased 204 basis points, from 8.29% to 10.33%, and the notes provided a positive annualized return of 7.00%. This return is approximately comprised of a principal loss of 3% offset by interest earned of 10%. In the same decade, yields on 20-year Treasury bonds increased 325 basis points, from 6.87% to 10.12% and the bonds generated a positive annualized return of 5.50%. Again the return is approximately comprised of a capital loss of 4.5% offset by interest earned of 10%.

Annualized Return	5-Year UST			20-Year Treasury			Inflation
	Start Yield	End Yield	Return	Start Yield	End Yield	Return	
1940’s	0.98%	1.23%	1.80%	2.26%	2.09%	3.20%	5.40%
1950’s	1.23%	4.98%	1.30%	2.09%	4.47%	-0.10%	2.20%
1960’s	4.98%	8.29%	3.50%	4.47%	6.87%	1.40%	2.50%
1970’s	8.29%	10.33%	7.00%	6.87%	10.12%	5.50%	7.40%
40-Year Annualized Return			3.40%			2.50%	

How Will Stocks Perform if Interest Rates Rise?

It is true that stocks perform well in many periods of declining bond yields. As yields decline, bonds become more expensive and stocks, by comparison, are perceived as offering a better value. However, there have been many periods where this has not been the case. The underlying causes of declines in yields needs to be evaluated to understand the potential impact on stock prices.

In both the Great Depression of 1929-1933 and the decade of 2000-2009, bond yields declined as a result of a slowdown in economic growth and reduced expectations for future inflation. Stock prices also declined over these periods as



expectations for future earnings growth moderated. Crisis events causing greater than normal levels of uncertainty, such as war or political or regulatory change, may also cause bond yields to decline as capital moves in a “flight to quality” to Treasury bonds as a risk-free safe haven. As reference Treasury yields decline, yields on other corporate and other bond securities also decline.

The period 1940-1979 represents a 40-year period of economic growth and rising bond yields. Stock prices rose in each decade over this period and generated a 10.4% annualized return. Growth in economic activity translated into growth in corporate earnings, the primary fundamental driver of stock prices.

Annualized Return	S&P 500 Return	20-Year Treasury		Return	Inflation
		Start Yield	End Yield		
1940's	9.20%	2.26%	2.09%	3.20%	5.40%
1950's	19.40%	2.09%	4.47%	-0.10%	2.20%
1960's	7.80%	4.47%	6.87%	1.40%	2.50%
1970's	5.90%	6.87%	10.12%	5.50%	7.40%
40-Year Annualized Return	10.40%			2.50%	

Low bond yield environments such as we have in 2010 also create opportunities for corporations to increase the value of their stock. PepsiCo Inc. recently issued \$500 million of three-year notes yielding 0.88%. If PepsiCo management is successful in employing this capital in activities that will yield greater than 0.88%, stockholder value will improve. These activities may include expansion of capacity, introduction of new products or other fundamental business activities. Inexpensive debt also enables corporations to utilize their capital structures to enhance stock values. These activities may include share repurchases, increased dividends and acquisitions of competitors or complementary businesses.

Conclusions

Disciplined investors recognize that stock and bond prices fluctuate based on fundamental economic factors, but over time assets also fall in and out of favor with the marketplace. All too often, investors increase allocations to investments that have performed well in the recent past, not recognizing that the higher prices being paid reduce the probability of future positive performance. As investment prices are ultimately tied to their fundamental values, high returns in the past serve to diminish the probability of high returns in the future.

In the current environment, near record low interest rates indicate a high valuation level for bonds, while the low P/E ratio of the S&P 500 indicates a more moderate valuation level for stocks. Bond yields will increase at some point in the future and move toward their long term average levels, resulting in capital losses for bonds. To position portfolios to guard against the eventual rise of interest rates, investors should shorten maturities of bonds and consider floating rate notes and TIPS. While gold and other “doomsday scenario” investments have been productive in the recent past, future performance is difficult to predict as speculation, not underlying fundamental value, has been the key driver of price changes for these investments. Hedge funds can play an important role in portfolio risk reduction and return generation by providing investors with the potential to generate gains from both long and short positions in stock and bond markets. If rates reverse course and start to rise, shorting bonds at current high valuation levels will provide attractive returns.

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